

**Bankruptcy Closing Actions Do Not Always
Protect the Federal Government's Interests
and Taxpayer Rights**

March 2003

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 27, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Bankruptcy Closing Actions Do Not Always
Protect the Federal Government's Interests and Taxpayer Rights
(Audit # 200230014)

This report presents the results of our review of the Internal Revenue Service's (IRS) Bankruptcy Closing Actions. The overall objective of this review was to determine if the IRS was effectively processing bankruptcy discharges¹ and dismissals² to achieve its goal of protecting the Government's interests while also protecting taxpayer rights.

Each year, the IRS processes numerous bankruptcy cases involving hundreds of thousands of taxpayers and billions of dollars. For example, during Fiscal Year (FY) 2001, IRS data showed the Insolvency Units opened approximately 577,600 bankruptcy cases on taxpayers owing \$2.7 billion in taxes, penalties, and interest. The IRS reported that during FY 2001 the Insolvency Units closed 586,400 bankruptcy cases and collected approximately \$589 million.

The IRS' Insolvency Units need to improve the timeliness and accuracy of bankruptcy case closures. Our review of 266 bankruptcy cases in 2 Insolvency Units identified delays in closing the bankruptcy on 92 taxpayers' accounts. Delays were identified on 19 (14 percent) of 136 bankruptcy cases closed by the court during FY 2001, and 73 (56 percent) of 130 bankruptcy cases that were open for over 5 years (see

¹ A discharge is a court order that relieves a debtor from liability for certain debts. It operates as an injunction against any collection action to recover discharged debts from the debtor.

² A dismissal is the term used when a bankruptcy proceeding is terminated prematurely. Debts are not forgiven, and the debtor does not receive a discharge.

Appendix V for details on the separate samples). These delays occurred because either the Insolvency Units were not timely identifying bankruptcy cases that had been closed by the court, or were not timely processing the bankruptcy case closures when court closure notices were received. In addition, management and employees did not effectively use controls, such as transcripts and reports, to enhance the timeliness of processing.

The delays in bankruptcy case closures resulted in delayed collection on 51 taxpayers' accounts with \$956,907 in post-petition liabilities³ and liabilities that were not discharged in the bankruptcy.

- Collection was resumed, but not timely, on 13 taxpayers' accounts involving \$86,561.
- Collection had not been resumed at the time of our review on 38 taxpayers' accounts involving \$870,346. The opportunity for collection was lost on \$459,143 for 4⁴ of the 38 taxpayers when the Collection Statute Expiration Date (CSED)⁵ expired. However, we recognize that not all of the balance due amounts may have been collected because it is likely that some of the taxpayers would be unable to fully pay.

In addition, taxpayer rights were not protected when the IRS did not refund credits timely and resumed collection action on liabilities that had been discharged in bankruptcy; these are called "discharge injunction violations." We identified refunds for \$49,009 for 18 taxpayers that were delayed or not issued at the time of our review for between 102 and 2,520 days (an average of 736 days). This includes refunds of \$9,473 for 6 taxpayers that were cancelled when refund statute⁶ expiration indicators erroneously posted while the accounts were in bankruptcy. In addition, the IRS' incomplete or improper closure actions resulted in liabilities of \$35,152 for 5 taxpayers' accounts being returned to the collection inventory after the liability had been discharged in bankruptcy.

We recommended the Director, Compliance, Small Business/Self-Employed Division, instruct Insolvency Unit managers to identify and review all taxpayer accounts with a bankruptcy indicator open over a certain period of time (e.g., 5 years) on the Master File⁷ and take appropriate action to return accounts to active collection status. The Director should also prioritize planned changes for the Litigation Account Management

³ Post-petition liabilities are tax liabilities from tax returns filed after the bankruptcy petition date.

⁴ In one of the four cases, the Insolvency Unit had annotated the file that the statute was expired, but the account was still in bankruptcy status at the time of our review.

⁵ The CSED is a time period established by law to collect taxes. Since November 5, 1990, the CSED is 10 years from the date of the assessment. Prior to November 5, 1990, the CSED was 6 years.

⁶ Title 26 U.S.C. Section 6511 limits the taxpayer's claim for a refund to 3 years from the return due date or timely extended due date, whichever is later.

⁷ The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

System (LAMS)⁸ to make its reports available to Insolvency Unit managers. The Director should issue a memorandum re-emphasizing the 30-day time standard for closing bankruptcy cases and the importance of closing bankruptcy cases timely and accurately. Changes should be made to the AIS⁹ "Case Closing Time Report" to provide management with a more reliable measure of the time required to close cases. Insolvency Unit managers should receive additional training on the purpose and use of the AIS and various reports. Finally, the AIS should provide a report similar to the "Chapter 7 Overdue Court Closure Report" that would identify Chapter 13 cases with the highest potential for being closed.

Management's Response

Management's response was due on March 14, 2003. As of March 25, 2003, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

⁸ The LAMS is a sub-system to the Automated Insolvency System (AIS) that is used to monitor compliance for all debtors in Chapters 11, 12, and 13 bankruptcies. The LAMS can generate several reports, including a match on closed cases on the AIS where there are unreversed bankruptcy transaction codes. However, the LAMS has not been available for Insolvency Units to use since October 2001.

⁹ The AIS is the IRS' database used to monitor bankruptcy case processing and was designed to control, track, and monitor bankruptcy cases.

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the Federal Government's Interests and Taxpayer Rights**

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Background

A debtor is a person or business that incurs financial liability and owes money to another person or business, called the creditor. When debtors cannot meet financial obligations to their creditors, debtors can petition (file) for bankruptcy with the Federal Bankruptcy Court.

During Fiscal Year (FY) 2001, approximately 1.4 million individuals and businesses filed for bankruptcy. While the Internal Revenue Service (IRS) is not a creditor to each of them, a significant number of these debtors have outstanding tax liabilities. As a result, each year the IRS processes bankruptcy cases involving hundreds of thousands of taxpayers and billions of dollars. For example, for FY 2001, IRS data showed that the Insolvency Unit opened approximately 577,600 bankruptcy cases on taxpayers owing \$2.7 billion in taxes, penalties, and interest. During FY 2001, the IRS reported that the Insolvency Unit closed 586,400 bankruptcy cases and collected approximately \$589 million.

The Bankruptcy Code¹ provides for five basic types of bankruptcy cases:

- Chapter 7 is a court-supervised procedure in which a trustee collects the assets of the debtor's estate, reduces them to cash, and distributes the cash to the creditors.
- Chapter 9 is a reorganization of a municipality, which includes villages, counties, taxing districts, municipal utilities, and school districts.
- Chapter 11 is generally used by businesses that want to continue to operate and repay creditors while they are reorganizing their business.
- Chapter 12 is used by farmers with regular annual income.
- Chapter 13 is designed for an individual debtor who has a regular source of income. The debtor proposes a plan to repay creditors over time.

¹ 11 United States Code (U.S.C.) Section 109 (1994).

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The Bankruptcy Code, 11 U.S.C. Section 524(a), relieves or discharges² the debtor of certain liabilities depending on the bankruptcy chapter filed. Debtors with the ability to pay their debts are dismissed³ from bankruptcy. Individual debtors filing Chapter 7 bankruptcy have tax liabilities that are over 3 years old discharged. Any tax liabilities arising from the most current 3 tax years are not dischargeable and are collectable through the bankruptcy. Debtors filing Chapter 13 bankruptcy usually receive a “super discharge” that abates any remaining tax liabilities at the completion of their payment plan.

Violations of the discharge injunction, such as an attempt to collect a discharged delinquent account, can result in embarrassment to the IRS and violation of taxpayers' rights. Additionally, the Internal Revenue Code (I.R.C.), 26 U.S.C. Section 7433(e), generally provides that taxpayers can recover damages from the IRS if an employee willfully violates the provisions of the Bankruptcy Code. The I.R.C. provides for actual damages up to \$1,000,000 for reckless or intentional disregard for provisions of the I.R.C., and \$100,000 for instances involving negligence.

The IRS' Insolvency Units have responsibility for controlling and monitoring bankruptcy cases. The Insolvency Units maintain an automated control system of cases filed under the Bankruptcy Code, called the Automated Insolvency System (AIS). This is a comprehensive control and processing application for the Insolvency Units to use when processing bankruptcy cases.

The Insolvency Units receive discharge and dismissal notices from the Bankruptcy Court either by electronic transmission or by mail. Electronically transmitted closure notices are loaded automatically to the AIS, and case closure notices received through the mail are input manually. After the Bankruptcy Court accepts the filing of

² A discharge is a court order that relieves a debtor from liability for certain debts. It operates as an injunction against any collection action to recover discharged debts from the debtor.

³ A dismissal is the term used when a bankruptcy proceeding is terminated prematurely. Debts are not forgiven, and the debtor does not receive a discharge.

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a debtor's bankruptcy petition, it prohibits creditors from attempting to collect the debt.⁴

The IRS' procedures require the Insolvency Units to close a bankruptcy case whenever no further action is necessary. This is generally the time that:

- A bankruptcy case is closed (receipt of distribution on Chapter 7 cases, and completion of the payment plan in Chapter 11 cases).
- The case is dismissed.
- A discharge is granted or denied.

When the Bankruptcy Court discharges the debtor, the Insolvency Units input case closing actions (e.g., transactions to abate the appropriate liability) to the Integrated Data Retrieval System (IDRS).⁵ After the case closure actions are completed or if the Bankruptcy Court dismisses the debtor, the Insolvency Units release the bankruptcy freeze, which automatically resumes collection activity on liabilities that remain after the bankruptcy and any post-petition liabilities.⁶

Our review was conducted from November 2001 through August 2002. We reviewed information and cases from the Small Business/Self-Employed (SB/SE) Division's Insolvency Territory 6 (Detroit, Michigan) and Insolvency Territory 13 (San Jose, California). The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Our review of closed bankruptcy cases showed that the Insolvency Units were not effectively managing bankruptcy case closures to ensure that the Federal Government's interests were protected and taxpayer rights were not being

The Insolvency Units Are Not Effectively Managing Bankruptcy Case Closures

⁴ The Bankruptcy Code, 11 U.S.C. Section 362; this is known as the automatic stay.

⁵ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁶ Post-petition liabilities are tax liabilities from tax returns filed after the bankruptcy petition date.

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violated. Managers and technicians were either not using or not effectively using information transcripts available from the Litigation Transcript System (LTS)⁷ and reports from the AIS and the Litigation Account Management System (LAMS),⁸ or creating *ad hoc* AIS queries. Effectively using these controls would help the Insolvency Units better identify bankruptcy cases that need to be worked, in order to protect both the IRS' and taxpayers' interests.

The Internal Revenue Manual requires the Insolvency Units to close bankruptcy cases within 30 days of the receipt of the court closure notice. The current "Case Closing Time Report" does not measure these criteria and, therefore, does not provide managers with meaningful information to evaluate the timeliness of case closures. The report measures the time from the date of the court closure to the closure date on the AIS.

The AIS generates a "Chapter 7 Overdue Court Closure Report." This report provides managers and technicians with a list of cases that have been open longer than the average time that recently closed cases were open. A similar report for Chapter 13 cases is not available from the AIS. Our analysis of the Chapter 7 "no asset" cases on the "Chapter 7 Overdue Court Closure Report" showed 35 of 58 cases in 1 Insolvency Unit and 136 of 325 cases in the other Insolvency Unit had been closed by the court. Further, our analysis showed 24 (68 percent) of 35 cases in 1 unit, and 134 (98 percent) of 136 cases in the other unit, remained open on the AIS an average of over 400 days after the court closure. Managers in the two units indicated that they are not using this report.

⁷ The LTS matches electronic litigation transcripts from the Master File (the IRS' database that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data) with the Taxpayer Identification Number records of the AIS database.

⁸ The LAMS is a sub-system of the AIS that is used to monitor compliance for all debtors in Chapters 11, 12, and 13 bankruptcies. The LAMS can generate several reports, including a match on closed cases on the AIS which contain unreversed bankruptcy indicators. However, the LAMS has not been available for Insolvency Units' use since October 2001.

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To determine if the Federal Government's interest and taxpayers' rights were being protected on bankrupt taxpayers' accounts, we reviewed statistically valid samples of:

- Bankruptcy cases on the AIS that had a "closed by the court" date during FY 2001.
- Accounts on the Taxpayer Service and Returns Processing Categorization (TRCAT)⁹ that have been in bankruptcy status for longer than 5 years.

For more information about the separate samples and detailed results, see Appendix V.

Collection action was not always resumed timely after bankruptcy cases were closed by the court

The IRS' procedures require the Insolvency Units to close a bankruptcy case within 30 days whenever no further action is necessary. This is generally the time that:

- A bankruptcy case is closed (e.g., receipt of distribution on Chapter 7 cases, and completion of the payment plan in Chapter 11 cases).
- The case is dismissed.
- A discharge is granted or denied.

The IRS did not timely resume collection action on some taxpayers' accounts after the Bankruptcy Court closed the bankruptcy. As a result, the Federal Government's interest was not adequately protected.

Our review of the closing actions for 266 bankruptcy cases identified 92 taxpayers' accounts for which the Insolvency Units delayed closing the bankruptcy on the Master File. We counted cases as "delayed" when they took more than 60 days to close. As a result, collection action on 51 of the 92 taxpayers' accounts was either not resumed timely, or

⁹ The TRCAT is a monthly extract from the IRS' main computer files of all accounts with a balance due as of the date of the extract. Accounts are categorized for statistical analyses according to their current collection status.

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not resumed at all as of the time of our review, on accounts involving \$956,907, as follows:

- Collection action for 13 of the 51 taxpayers was resumed, but not timely, involving approximately \$86,561.
- Collection action for the remaining 38 taxpayers, on tax liabilities totaling \$870,346, had not been resumed at the time of our review. Furthermore, the opportunity for collection had been lost on \$459,143 owed by 4¹⁰ of the 38 taxpayers when the Collection Statute Expiration Date (CSED)¹¹ expired. However, we recognize that not all of the balance due amounts may have been collected because it is likely that some of the taxpayers would be unable to fully pay.

There were delayed closings on the remaining 41 of the 92 taxpayers' accounts; however, the collection status was not affected because these accounts did not have a balance due.

Based upon our statistically valid sample, we project that closure actions were not timely on 3,786 taxpayers' accounts in the 2 Insolvency Units. While delays in closing the bankruptcy cases did not always affect the Federal Government's opportunity to collect the taxes owed, we project that collection was delayed on 1,550 of the 3,786 taxpayers' accounts, consisting of 890 accounts in which collection action was not resumed timely and another 660 in which no collection had resumed at the time of our review. We also project that the collection opportunity had been lost on 60 taxpayers' accounts because the CSED had expired.

¹⁰ In one of the four cases, the Insolvency Unit had annotated the file that the statute was expired, but the account was still in bankruptcy status at the time of our review.

¹¹ The CSED is a time period established by law to collect taxes. Since November 5, 1990, the CSED is 10 years from the date of the assessment. Prior to November 5, 1990, the CSED was 6 years.

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Taxpayers' rights were not always protected when bankruptcy cases were closed

Taxpayers should be provided refunds when bankruptcy payment plan overpayments occur or credits exist on returns filed post-petition. In our sample of 266 accounts, 18 taxpayers' refunds totaling \$49,009 were not issued at the time of our review or were delayed in their issuance for between 102 and 2,520 days (an average of 736 days). This includes refunds of \$9,473 for 6 taxpayers that were cancelled when refund statute¹² expiration indicators erroneously posted while the accounts were in bankruptcy. Based on our statistically valid sample, we project that 1,187 taxpayers' accounts may have had refunds that were either delayed or not issued because the refund was frozen while the account was in bankruptcy. This includes a projected 299 taxpayers who did not receive refunds because the refund statute erroneously expired while the accounts were in bankruptcy.

In addition, taxpayers' rights were not always protected when technicians were required to manually input case closure actions. Incomplete or improper closure actions resulted in liabilities of \$35,152 for 5 taxpayers' accounts being returned to collection status after the liability had been discharged in bankruptcy. The IRS' Insolvency Units identified and corrected two of these taxpayers' accounts. The IRS' Insolvency Units corrected another two taxpayers' accounts when the taxpayers called after receiving notices. The final case had not yet been identified or corrected by the IRS Insolvency Unit at the time of our review. Based on our statistically valid sample, we project that 73 taxpayers received a notice regarding liabilities that had been discharged by the Bankruptcy Court.

In addition to ineffective use of transcripts and reports, these problems occurred because management reviews and approvals of closure actions were not effective to ensure the

¹² Title 26 U.S.C. Section 6511 limits the taxpayer's claim for a refund to 3 years from the return due date or timely extended due date, whichever is later.

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accuracy and completeness of closure actions when manual processing was required to complete the case closure.

Recommendations

The Director, Compliance, SB/SE Division, should:

1. Instruct Insolvency Unit managers to identify and review all taxpayer accounts with a bankruptcy indicator that has been open over a certain period of time (e.g., 5 years) on the Master File. Appropriate action should be taken on accounts for which the Bankruptcy Court has closed the bankruptcy. Appropriate actions should also be taken on accounts for which there are no records on the AIS and there is no record of a bankruptcy with the Bankruptcy Court.

Management's Response: Management's response was due on March 14, 2003. As of March 25, 2003, management had not responded to the draft report.

2. Submit a Request for Information Services (RIS) to make the LAMS reports available to Insolvency Unit managers. The LAMS reports have not been available to Insolvency Unit managers since October 2001.
3. Re-emphasize, through a memorandum to the Insolvency Units, the time standards for closing bankruptcy cases and the importance of closing bankruptcy cases timely and accurately.
4. Enhance the AIS "Case Closing Time Report" to provide management with a reliable measure of time from the receipt of the notice to actual case closure. The current report measures the time from the Bankruptcy Court closure to the case closure on the AIS.
5. Provide Insolvency Unit managers with additional training on the purpose and use of the AIS, the LTS, and the LAMS transcripts and reports. Insolvency Unit managers should also receive training on using

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ad hoc queries on the AIS to more effectively manage their groups' inventories.

6. Submit a RIS for the AIS to provide management with a report that would identify Chapter 13 cases that have the highest potential for being closed. The AIS currently provides an "Overdue Court Closure Report" only for Chapter 7 cases.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Internal Revenue Service (IRS) was effectively processing bankruptcy discharges¹ and dismissals² to achieve its goal of protecting the Federal Government's interests while also protecting taxpayer rights.

- I. Determined if the IRS protected the Federal Government's interests by closing bankruptcy cases timely and accurately.
 - A. Interviewed Insolvency Unit managers and tax examiners to identify procedures and time requirements for closing bankruptcy cases, and to identify management information used to monitor and control bankruptcy case closures.
 - B. Obtained a download of all taxpayer accounts on the Taxpayer Service and Returns Processing Categorization (TRCAT)³ that were in bankruptcy status for over 5 years. Identified 869 and 1,081 taxpayers' accounts in Insolvency Territory 6 and Insolvency Territory 13, respectively. We selected statistically valid samples of 65 taxpayer accounts in 2 Insolvency Units. The samples had a confidence level of 90 percent, a precision level of plus or minus 10 percent, and an estimated error rate of 50 percent.
 - 1. Reviewed samples of 65 taxpayers' accounts from each Insolvency Unit (130 total) to determine the status of the bankruptcy cases at the Bankruptcy Court.
 - 2. Determined if the cases had been closed by the Bankruptcy Court and/or on the Automated Insolvency System (AIS).⁴
 - C. Selected a statistically valid sample of 136 bankruptcy cases that had been closed during Fiscal Year (FY) 2001 on the AIS. The sample had a confidence level of 90 percent, a precision level of plus or minus 10 percent, and an estimated error rate of 50 percent.

¹ A discharge is a court order that relieves a debtor from liability for certain debts. It operates as an injunction against any collection action to recover discharged debts from the debtor.

² A dismissal is the term used when a bankruptcy proceeding is terminated prematurely. Debts are not forgiven, and the debtor does not receive a discharge.

³ The TRCAT is a monthly extract from the IRS main computer files of all accounts with a balance due as of the date of the extract. Accounts are categorized for statistical analyses according to their current collection status.

⁴ The AIS is the IRS' database used to monitor bankruptcy case processing and was designed to control, track, and monitor bankruptcy cases.

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1. Verified the accuracy of the Bankruptcy Court closing date and Court closing action (i.e., discharge or dismissal) on the AIS.
 2. Verified the accuracy of the Bankruptcy Court closure date on the Master File.⁵
 3. Determined whether all appropriate plan payments for secured and priority claims had been received (Chapters 11, 12, and 13 bankruptcies) based on the payment information shown on the AIS.
 4. Determined if the Insolvency Units timely and accurately recorded the case closure actions on the AIS and the Master File.
- D. Reviewed the AIS' "Chapter 7 Overdue Court Closure Report," and the Litigation Accounts Management System's (LAMS)⁶ "Not Found On AIS Case Listing" and "Potentially Unreversed TC 520" reports, to determine if timely closure actions were taken by the Insolvency Units.
- II. Determined if the IRS adequately protected taxpayers' rights during discharge.
- A. Reviewed cases that had been closed by the Bankruptcy Court from the statistically valid sample selected in Objective 1.B.
1. Determined if any automatic stay violations were appropriately resolved at case closure.
 2. Determined if discharged liabilities were abated timely and accurately on bankruptcy cases that had been discharged by the Bankruptcy Court.
- B. Reviewed the bankruptcy cases from the statistically valid sample from Objective 1.C.
1. Determined if automatic stay violations were appropriately resolved at case closure.
 2. Determined if discharged liabilities were abated timely and accurately on bankruptcy cases that had been discharged by the Bankruptcy Court.

⁵ The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁶ The LAMS is a sub-system of the AIS that is used to monitor compliance for all debtors in Chapters 11, 12, and 13 bankruptcies. The LAMS can generate several reports, including a match on closed cases on the AIS where there are unreversed bankruptcy indicators. However, the LAMS has not been available for Insolvency Units to use since October 2001.

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Appendix III

Report Distribution List

Acting Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Filing and Payment Compliance, Small Business/Self-Employed Division S:C:CP:FP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
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Office of Management Controls N:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division S:C:CP:I

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; \$14,758 on 6 taxpayers' accounts with a bankruptcy closed by the Bankruptcy Court during Fiscal Year (FY) 2001 on the Automated Insolvency System (AIS),¹ where collection activity was either not resumed at the time of our review or not resumed timely (see page 3 and Appendix V). Potential; collection was not resumed timely or had not resumed at the time of our review on another estimated 884 of 22,159 taxpayers' accounts² that were closed by the Bankruptcy Court in the 2 Insolvency Units we reviewed during FY 2001.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 136 taxpayers' accounts that the AIS showed as closed by the Bankruptcy Court during FY 2001.

Applying the actual error rate of 4.02 percent to the universe of 22,159 taxpayers with closed bankruptcies during FY 2001 resulted in a projection of 890 taxpayers' accounts with delayed collection. We are unable to project the potential liabilities associated with the 890 taxpayers' accounts.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; \$942,149 on 45 taxpayers' accounts in bankruptcy status for over 5 years on the Master File³ for which collection activity was either not resumed at the time of our review or not resumed timely. The opportunity to collect was lost on \$459,143 on 4 taxpayers' accounts when the Collection Statute Expiration Date (CSED)⁴ expired while the accounts remained in bankruptcy status erroneously (see page 3 and Appendix V). Potential; collection was not resumed timely or had not resumed at the time of our review on

¹ The AIS is the Internal Revenue Service's (IRS) database used to monitor bankruptcy case processing and was designed to control, track, and monitor bankruptcy cases.

² Statistical projection from the FY 2001 closed bankruptcy sample with a confidence level of 95 percent plus or minus 2.68 percent.

³ The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁴ The CSED is a time period established by law to collect taxes. Since November 5, 1990, the CSED is 10 years from the date of the assessment. Prior to November 5, 1990, the CSED was 6 years.

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an another estimated 615 of 1,950 taxpayers' accounts⁵ that had been in bankruptcy status on the Master File for over 5 years. We further project that the opportunity for collection has been lost on as many as another 56 of 1,950 taxpayers' accounts⁶ on the Master File because the CSED has expired while the accounts were erroneously in bankruptcy status.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 130 taxpayers' accounts that were in bankruptcy status on the Master File for over 5 years.

Applying the actual error rate of 33.86 percent to the universe of 1,950 taxpayers in bankruptcy on the Master File for over 5 years resulted in a projection of 660 taxpayers' accounts with delayed collection. We are unable to project the potential dollar amount associated with the 660 taxpayers' accounts.

Applying the actual error rate of 3.08 percent to the universe of 1,950 taxpayers in bankruptcy on the Master File for over 5 years resulted in a projection of 60 taxpayers' accounts with an expired CSED. We are unable to project the potential dollar amount associated with the 60 taxpayers' accounts.

Type and Value of Outcome Measure:

Taxpayer Rights and Entitlements – Actual; refunds of \$24,206 for 8 taxpayers with closed bankruptcies during FY 2001 were delayed, including \$6,009 for 2 taxpayers that were cancelled when refund statute⁷ expiration indicators erroneously posted while the accounts were in bankruptcy (see page 3 and Appendix V). Potential; an additional 1,033 taxpayers' accounts⁸ may have had refunds that were either delayed or not issued because the refund was frozen while the account was in bankruptcy. This includes a projected 239 taxpayers⁹ whose refunds were cancelled when refund statute expiration indicators erroneously posted while their accounts were in bankruptcy.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 136 taxpayers' accounts that the AIS showed as closed by the court during FY 2001.

⁵ Statistical projection of accounts in bankruptcy for over 5 years with a confidence level of 95 percent plus or minus 13.4 percent.

⁶ Statistical projection of accounts in bankruptcy for over 5 years with a confidence level of 95 percent plus or minus .09 percent.

⁷ Title 26 U.S.C. Section 6511 limits the taxpayers claim for a refund to 3 years from the return due date or timely extended due date, whichever is later.

⁸ Statistical projection of FY 2001 closed bankruptcy accounts and accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus 8.03 percent.

⁹ Statistical projection of FY 2001 closed bankruptcy accounts and accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus 2.68 percent.

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Applying the actual error rate of 4.70 percent to the universe of 22,159 taxpayers with closed bankruptcies during FY 2001 resulted in a projection of 1,041 taxpayers with refund delays. We are unable to project the potential refund amounts associated with the 1,041 taxpayers.

Applying the actual error rate of 1.08 percent to the universe of 22,159 taxpayers with closed bankruptcies during FY 2001 resulted in a projection of 239 taxpayers whose refunds were cancelled when refund statute expiration indicators erroneously posted while the accounts were in bankruptcy. We are unable to project the potential refund amounts associated with the 239 taxpayers.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; refunds of \$24,803 for 10 taxpayers in bankruptcy status for over 5 years on the Master File were delayed, including refunds of \$3,465 for 4 taxpayers that were cancelled when refund statute expiration indicators erroneously posted while the accounts were in bankruptcy (see page 3 and Appendix V). Potential; an additional 136 taxpayers' accounts¹⁰ may have had refunds that were either delayed or not issued because the refund was frozen while the account was in bankruptcy. This includes a projected 60 taxpayers¹¹ whose refunds were cancelled because the refund statute erroneously expired while the accounts were in bankruptcy.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 130 taxpayers' accounts that were in bankruptcy status on the Master File for over 5 years.

Applying the actual error rate of 7.53 percent to the universe of 1,950 taxpayers in bankruptcy on the Master File for over 5 years resulted in a projection of 146 taxpayers' accounts with refund delays. We are unable to project the potential refund amounts associated with the 146 taxpayers' accounts.

Applying the actual error rate of 3.08 percent to the universe of 1,950 taxpayers in bankruptcy on the Master File for over 5 years resulted in a projection of 60 taxpayers whose refunds were cancelled when the refund statute erroneously expired while their accounts were in bankruptcy. We are unable to project the potential refund amounts associated with the 60 taxpayers' accounts.

¹⁰ Statistical projection of FY 2001 closed bankruptcy accounts and accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus 2.98 percent.

¹¹ Statistical projection of FY 2001 closed bankruptcy accounts and accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus .09 percent.

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Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; 5 taxpayers in bankruptcy status for over 5 years on the Master File received notices regarding liabilities of \$35,152 that had been discharged by the Bankruptcy Court (see page 3). Potential; an additional 68 taxpayers¹² may have received notices regarding liabilities that had been discharged by the Bankruptcy Court.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 130 taxpayers' accounts that were in bankruptcy status on the Master File for over 5 years.

Applying the actual error rate of 3.76 percent to the universe of 1,950 taxpayers from our sample resulted in a projection of 73 taxpayers who received a notice regarding liabilities that had been discharged by the Bankruptcy Court. We are unable to project the dollar amount of the potential liabilities associated with the 73 taxpayers' accounts.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 5 taxpayers in bankruptcy status for over 5 years on the Master File with liabilities of \$38,633 were not on the AIS or on the Public Access to Court Electronic Records (PACER)¹³ system (see Appendix V). Potential; an additional 74 taxpayers¹⁴ may be in bankruptcy status on the Master File and were not on the AIS or the PACER system.

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 130 taxpayers' accounts that were in bankruptcy status on the Master File for over 5 years.

Applying the actual error rate of 4.10 percent to the universe of 1,950 taxpayers from our sample resulted in a projection of 79 taxpayers who may be in bankruptcy status on the Master File and were not on the AIS system or the PACER system. We are unable to project the dollar amount of the potential liabilities associated with the 79 taxpayers.

¹² Statistical projection of accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus 1.49 percent.

¹³ The PACER system is an electronic public access service that allows users to request case and docket information about a particular individual or case. It provides a listing of new cases each day and contains updates to active and recently closed bankruptcy cases. Each Bankruptcy Court maintains its own database with case information.

¹⁴ Statistical projection of accounts in bankruptcy over 5 years with a confidence level of 95 percent plus or minus 4.47 percent.

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Appendix V

Details of the Treasury Inspector General for Tax Administration Case Review

Figure 1 represents the details of our review to determine whether collection actions were timely resumed after bankruptcy cases were closed by the Bankruptcy Court.

Figure 1: Summary of Sample Case Reviews

<u>Type of Case</u>	<u>Number of Taxpayers Reviewed</u>	<u>Total Errors Identified</u>	<u>Number Resumed, but Not Timely</u>	<u>Number Still Not Resumed</u>
Cases Closed by the Court During Fiscal Year (FY) 2001	136	19	17	2
Master File¹ Accounts in Bankruptcy for Over 5 Years	130	73	17	56*
Totals	266	92	34	58

Source: Treasury Inspector General for Tax Administration analysis of cases on the Automated Insolvency System²(AIS) Closed by the Court During Fiscal Year (FY) 2001 and Master File Accounts in Bankruptcy for Over 5 years.

* The bankruptcies for five of these taxpayers' accounts were not on the AIS or the PACER³ system. We could not determine if these were legitimate bankruptcy cases.

Cases on the AIS shown as closed by the Bankruptcy Court during FY 2001:

We reviewed a statistically valid sample of 136 taxpayers' accounts that were shown as being closed by the Bankruptcy Court during FY 2001.

Figure 1 shows the bankruptcy cases for 19 taxpayers (14 percent) that were not closed timely by the Internal Revenue Service (IRS). The Federal Government's interest was not protected on 6 of

¹ The Internal Revenue Service's (IRS) database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

² The AIS is the Internal Revenue Service's (IRS) database used to monitor bankruptcy case processing and was designed to control, track, and monitor bankruptcy cases.

³ The Public Access to Court Electronic Records (PACER) system is an electronic public access service that allows users to request case and docket information about a particular individual or case. It provides a listing of new cases each day and contains updates to active and recently closed bankruptcy cases. Each Bankruptcy Court maintains its own database with case information.

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these accounts when collection activity on \$14,758 was not resumed for an average of 146 days, as follows:

Collection was delayed an average of 118 days on liabilities of 3 taxpayers, totaling \$5,101, which was not discharged.⁴

- Collection action had not been resumed for 358 days at the time of our review on \$1,451 that was not discharged in bankruptcy on another taxpayer's account.
- Collection action was delayed an average of 188 days on post-petition⁵ liabilities of \$8,206 that were accumulated while 2 taxpayers were in bankruptcy.

Also, in our sample of 136 accounts, refunds of \$24,206 for 8 taxpayers were delayed, including \$6,009 that was not refunded to 2 taxpayers because the refund statute⁶ expired while the refund was frozen by the bankruptcy. Based on this, we projected that 1,041 taxpayers' accounts may have had refunds that were either delayed or not issued because the refund was frozen while the account was in bankruptcy. This also includes a projected 239 taxpayers who did not receive refunds because the refund statute expired while the refund was frozen by the bankruptcy.

Accounts in Bankruptcy Status for Over 5 Years

We also reviewed a statistically valid sample of 130 of 1,950 taxpayers' accounts on the Master File from 2 Insolvency Units. These taxpayers' accounts were in balance due status on the Master File and had been in bankruptcy status for over 5 years. Figure 1 shows we identified delays or no action taken to close the bankruptcy on 73 (56 percent) taxpayers averaging 1,328 days. The Federal Government's interest was not protected when collection was not resumed timely after the Bankruptcy Court closed the bankruptcy on liabilities of \$942,149 for 45 taxpayers. These liabilities either survived the bankruptcy or were post-petition liabilities. In particular:

- Collection action on liabilities totaling approximately \$868,895 for 37 of these taxpayers had not been resumed from 73 to 3,812 days (an average of 1,465 days) at the time of our review. Extensive delays in resuming collection resulted in the Collection Statute Expiration Date (CSED)⁷ expiring on over \$459,143 on 4 taxpayers' accounts.
- Collection action was resumed, but not timely, on \$73,254 for another 8 taxpayers.

The remaining 28 of the 73 cases had delays but the collection status was not affected because these accounts did not have a balance due.

⁴ A discharge is a court order that relieves a debtor from liability for certain debts. It operates as an injunction against any collection action to recover discharged debts from the debtor.

⁵ Post-petition liabilities are tax liabilities from tax returns filed after the bankruptcy petition date.

⁶ Title 26 U.S.C. Section 6511 limits the taxpayers claim for a refund to 3 years from the return due date or timely extended due date, whichever is later.

⁷ The CSED is a time period established by law to collect taxes. Since November 5, 1990, the CSED is 10 years from the date of the assessment. Prior to November 5, 1990, the CSED was 6 years.

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In our review of the 130 cases, we were unable to determine the correct status of liabilities totaling \$38,633 on 5 taxpayer accounts. There was no record of these cases on the AIS or on the PACER system. Due to the volume of bankruptcy cases, both systems are periodically purged of closed cases. These cases still had bankruptcy indicators; however, any collection potential has probably been lost because the petition dates on these bankruptcy cases were from over 8 to nearly 15 years old (averaging over 11 years old). The bankruptcy indicators on other tax periods for 1 taxpayer's account have been closed for over 6 years. Based on our statistically valid sample, we project that 79 taxpayers may be in bankruptcy status on the Master File and are not on the AIS or the PACER system.

Also, in our sample of 130 accounts, refunds of \$24,803 for 10 taxpayers were delayed, including \$3,465 that was not refunded to 4 taxpayers because the refund statute expired while the refund was frozen by the bankruptcy. Based on this, we projected that 146 taxpayers may have had refunds that were either delayed or not issued because the refund was frozen while the account was in bankruptcy. This also includes a projected 60 taxpayers who did not receive refunds because the refund statute expired while the refund was frozen by the bankruptcy.